

AMENDED IN ASSEMBLY MARCH 13, 2006
AMENDED IN ASSEMBLY FEBRUARY 16, 2006
AMENDED IN ASSEMBLY JULY 6, 2005
AMENDED IN SENATE MAY 17, 2005

SENATE BILL

No. 663

Introduced by Senator Migden
(Coauthor: Senator Machado)
(Coauthor: Assembly Member Jones)

February 22, 2005

An act to amend, repeal, and add Section 25110 of the Revenue and Taxation Code, relating to taxation, *to take effect immediately, tax levy.*

LEGISLATIVE COUNSEL'S DIGEST

SB 663, as amended, Migden. Corporation taxes: water's-edge election: foreign affiliated corporations.

Existing law provides that, in the case of a business with income derived from or attributable to sources both within and without this state, the income is apportioned between this state and the other states and foreign countries for tax purposes in accordance with a specified formula based on the property, payroll, and sales within and without this state. Existing law permits a qualified taxpayer, as defined, to elect to determine its income under a water's-edge election. A water's-edge election provides that only the income and apportionment factors of certain described affiliated corporations may be included for purposes of determining the taxpayer's income apportioned to this state.

Existing law requires that income and apportionment factors of a foreign corporation be included in the combined report of a taxpayer making a water's-edge election, but only to the extent of the foreign corporation's United States-source income and apportionment factors. The income and apportionment factors of a controlled foreign corporation, as defined in the Internal Revenue Code, that is an affiliated corporation of a taxpayer are included in the combined report of the taxpayer making a water's-edge election to the extent of the "Subpart F" income ratio, as determined under existing law. Existing law, however, does not specify whether the United States-source income rules or the rules regarding "Subpart F" income, as defined in the Internal Revenue Code, apply to income of a controlled foreign corporation that has both United States-source income and "Subpart F" income.

This bill would clarify that existing law prohibits a controlled foreign corporation from excluding its "Subpart F" income from a water's-edge combined report, even if it is a California taxpayer or has income from a United States source. This bill would also clarify that existing law requires inclusion in a water's-edge combined report of both United States-source income and Subpart F income of a controlled foreign corporation, regardless of whether the corporation is a California taxpayer. This bill would declare the intent of the Legislature that this clarification be operative for taxable years beginning on or after January 1, ~~2007~~ 2006. *This bill would also declare the intent of the Legislature that the manner in which a taxpayer reported specified income, as provided, on or before January 1, 2006, shall be deemed to be in compliance with existing law, as it read prior to the enactment of this act, and that no inference shall be drawn from this act as to the manner in which a taxpayer reported specified income after January 1, 2006.* This bill would require the Franchise Tax Board to promulgate regulations to prevent the potential double taxation of income when a controlled foreign corporation has both United States-source income and "Subpart F" income."

This bill would take effect immediately as a tax levy.

Vote: majority. Appropriation: no. Fiscal committee: yes.
State-mandated local program: no.

The people of the State of California do enact as follows:

1 SECTION 1. Section 25110 of the Revenue and Taxation
2 Code, as amended by Section 58 of Chapter 182 of the Statutes
3 of 2004, is amended to read:

4 25110. (a) Notwithstanding Section 25101, a qualified
5 taxpayer, as defined in paragraph (2) of subdivision (b), that is
6 subject to the tax imposed under this part, may elect to determine
7 its income derived from or attributable to sources within this
8 state pursuant to a water's-edge election in accordance with the
9 provisions of this part, as modified by this article. A taxpayer,
10 that made a water's-edge election prior to January 1, ~~2007~~ 2006,
11 shall take into account the income and apportionment factors of
12 the following affiliated entities only:

13 (1) Domestic international sales corporations, as described in
14 Sections 991 to 994, inclusive, of the Internal Revenue Code and
15 foreign sales corporations as described in Sections 921 to 927,
16 inclusive, of the Internal Revenue Code.

17 (2) Any corporation (other than a bank), regardless of the
18 place where it is incorporated if the average of its property,
19 payroll, and sales factors within the United States is 20 percent or
20 more.

21 (3) Corporations that are incorporated in the United States,
22 excluding corporations making an election pursuant to Sections
23 931 to 936, inclusive, of the Internal Revenue Code, of which
24 more than 50 percent of their voting stock is owned or controlled
25 directly or indirectly by the same interests.

26 (4) A corporation that is not described in paragraphs (1) to (3),
27 inclusive, or paragraph (5), but only to the extent of its income
28 derived from or attributable to sources within the United States
29 and its factors assignable to a location within the United States in
30 accordance with paragraph (3) of subdivision (b). Income of that
31 corporation derived from or attributable to sources within the
32 United States as determined by federal income tax laws shall be
33 limited to and determined from the books of account maintained
34 by the corporation with respect to its activities conducted within
35 the United States.

36 (5) Export trade corporations, as described in Sections 970 to
37 972, inclusive, of the Internal Revenue Code.

(6) Any affiliated corporation which is a “controlled foreign corporation,” as defined in Section 957 of the Internal Revenue Code, if all or part of the income of that affiliate is defined in Section 952 of Subpart F of the Internal Revenue Code (“Subpart F income”). The income and apportionment factors of any affiliate to be included under this paragraph shall be determined by multiplying the income and apportionment factors of that affiliate without application of this paragraph by a fraction (not to exceed one), the numerator of which is the “Subpart F income” of that corporation for that taxable year and the denominator of which is the “earnings and profits” of that corporation for that taxable year, as defined in Section 964 of the Internal Revenue Code.

(7) (A) The income and factors of the above-enumerated corporations shall be taken into account only if the income and factors would have been taken into account under Section 25101 if this section had not been enacted.

(B) The income and factors of a corporation that is not described in paragraphs (1) to (3), inclusive, and paragraph (5) and that is an electing taxpayer under this subdivision shall be taken into account in determining its income only to the extent set forth in paragraph (4).

(b) For purposes of this article and Section 24411 all of the following definitions apply:

(1) An “affiliated corporation” means a corporation that is a member of a commonly controlled group as defined in Section 25105.

(2) A “qualified taxpayer” means a corporation which does both of the following:

(A) Files with the state tax return on which the water’s-edge election is made a consent to the taking of depositions at the time and place most reasonably convenient to all parties from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board as provided in Section 19504 or by the State Board of Equalization as provided in Title 18, California Code of Regulations, Section 5005, or by the courts of this state as provided in Chapter 2 (commencing with Section 1985) of Title 3 of Part 4 of, and Chapter 9 (commencing with Section 2025.010) of Title 4 of Part 4 of, the Code of Civil

1 Procedure. The consent relates to issues of jurisdiction and
2 service and does not waive any defenses a taxpayer may
3 otherwise have. The consent shall remain in effect so long as the
4 water's-edge election is in effect and shall be limited to
5 providing that information necessary to review or to adjust
6 income or deductions in a manner authorized under Sections 482,
7 861, Subpart F of Part III of Subchapter N, or similar provisions
8 of the Internal Revenue Code, together with the regulations
9 adopted pursuant to those provisions, and for the conduct of an
10 investigation with respect to any unitary business in which the
11 taxpayer may be involved.

12 (B) Agrees that for purposes of this article, dividends received
13 by any corporation whose income and apportionment factors are
14 taken into account pursuant to subdivision (a) from either of the
15 following are functionally related dividends and shall be
16 presumed to be business income:

17 (i) A corporation of which more than 50 percent of the voting
18 stock is owned, directly or indirectly, by members of the unitary
19 group and which is engaged in the same general line of business.

20 (ii) Any corporation that is either a significant source of
21 supply for the unitary business or a significant purchaser of the
22 output of the unitary business, or that sells a significant part of its
23 output or obtains a significant part of its raw materials or input
24 from the unitary business. "Significant," as used in this
25 subparagraph, means an amount of 15 percent or more of either
26 input or output.

27 All other dividends shall be classified as business or
28 nonbusiness income without regard to this subparagraph.

29 (3) The definitions and locations of property, payroll, and
30 sales shall be determined under the laws and regulations that set
31 forth the apportionment formulas used by the individual states to
32 assign net income subject to taxes on or measured by net income
33 in that state. If a state does not impose a tax on or measured by
34 net income or does not have laws or regulations with respect to
35 the assignment of property, payroll, and sales, the laws and
36 regulations provided in Article 2 (commencing with Section
37 25120) shall apply.

38 Sales shall be considered to be made to a state only if the
39 corporation making the sale may otherwise be subject to a tax on
40 or measured by net income under the Constitution or laws of the

1 United States, and shall not include sales made to a corporation
2 whose income and apportionment factors are taken into account
3 pursuant to subdivision (a) in determining the amount of income
4 of the taxpayer derived from or attributable to sources within this
5 state.

6 (4) “The United States” means the 50 states of the United
7 States and the District of Columbia.

8 (c) All references in this part to income determined pursuant to
9 Section 25101 shall also mean income determined pursuant to
10 this section.

11 (d) (1) This section shall apply only to a taxable year of a
12 taxpayer that determines its income derived from or attributable
13 to sources within this state pursuant to a water’s-edge election
14 made prior to January 1, ~~2007~~ 2006, where that election may not
15 be terminated for that taxable year without the consent of the
16 Franchise Tax Board pursuant to paragraph (9) of subdivision (c)
17 of Section 25113.

18 (2) This section shall be repealed on January 1, 2014.

19 SEC. 2. Section 25110 is added to the Revenue and Taxation
20 Code, to read:

21 25110. (a) Notwithstanding Section 25101, a qualified
22 taxpayer, as defined in paragraph (2) of subdivision (b), that is
23 subject to the tax imposed under this part, may elect to determine
24 its income derived from or attributable to sources within this
25 state pursuant to a water’s-edge election in accordance with the
26 provisions of this part, as modified by this article. A taxpayer,
27 that makes a water’s-edge election on or after January 1, ~~2007~~
28 2006, shall take into account that portion of its own income and
29 apportionment factors and the income and apportionment factors
30 of its affiliated entities to the extent provided below:

31 (1) The entire income and apportionment factors of any of the
32 following corporations:

33 (A) Domestic international sales corporations, as described in
34 Sections 991 to 994, inclusive, of the Internal Revenue Code and
35 foreign sales corporations as described in Sections 921 to 927,
36 inclusive, of the Internal Revenue Code.

37 (B) Any corporation (other than a bank), regardless of the
38 place where it is incorporated if the average of its property,
39 payroll, and sales factors within the United States is 20 percent or
40 more.

1 (C) Corporations that are incorporated in the United States,
2 excluding corporations making an election pursuant to Sections
3 931 to 936, inclusive, of the Internal Revenue Code.

4 (D) Export trade corporations, as described in Sections 970 to
5 972, inclusive, of the Internal Revenue Code.

6 (2) (A) With respect to a corporation that is not described in
7 subparagraphs (A), (B), (C), and (D) of paragraph (1), as
8 provided in either one or both of the following clauses:

9 (i) The income and apportionment factors of that corporation
10 to the extent of its income derived from or attributable to sources
11 within the United States and its factors assignable to a location
12 within the United States in accordance with paragraph (3) of
13 subdivision (b). Income of that corporation derived from or
14 attributable to sources within the United States as determined by
15 federal income tax laws shall be limited to, and determined from,
16 the books of account maintained by the corporation with respect
17 to its activities conducted within the United States.

18 (ii) The income and apportionment factors of that corporation
19 that is a “controlled foreign corporation,” as defined in Section
20 957 of the Internal Revenue Code, to the extent determined by
21 multiplying the income and apportionment factors of that
22 corporation without application of this subparagraph by a
23 fraction not to exceed one, the numerator of which is the
24 “Subpart F income” of that corporation for that taxable year and
25 the denominator of which is the “earnings and profits” of that
26 corporation for that taxable year.

27 (B) For purposes of this paragraph, both of the following
28 apply:

29 (i) “Subpart F income” means “Subpart F income” as defined
30 in Section 952 of the Internal Revenue Code.

31 (ii) “Earnings and profits” means “earnings and profits” as
32 described in Section 964 of the Internal Revenue Code.

33 (3) The income and apportionment factors of the corporations
34 described in this subdivision shall be taken into account only to
35 the extent that they would have been taken into account had no
36 election under this section been made.

37 (4) The Franchise Tax Board shall prescribe regulations to
38 coordinate implementation of subparagraph (A) of paragraph (2)
39 to prevent multiple inclusion or exclusion of income and factors

1 in situations where the same item of income is described in both
2 clauses.

3 (b) For purposes of this article and Section 24411, all of the
4 following definitions apply:

5 (1) An “affiliated corporation” means a corporation that is a
6 member of a commonly controlled group as defined in Section
7 25105.

8 (2) A “qualified taxpayer” means a corporation that does both
9 of the following:

10 (A) Files with the state tax return, on which the water’s-edge
11 election is made, a consent to the taking of depositions, at the
12 time and place most reasonably convenient to all parties, from
13 key domestic corporate individuals and to the acceptance of
14 subpoenas duces tecum requiring reasonable production of
15 documents to the Franchise Tax Board, as provided in Section
16 19504, by the State Board of Equalization, as provided in Section
17 5005 of Title 18 of the California Code of Regulations, or by the
18 courts of this state, as provided in Chapter 2 (commencing with
19 Section 1985) of Title 3 of Part 4 of, and Chapter 9 (commencing
20 with Section 2025.010) of Title 4 of Part 4 of, the Code of Civil
21 Procedure. The consent relates to issues of jurisdiction and
22 service and does not waive any defenses that a taxpayer may
23 otherwise have. The consent shall remain in effect as long as the
24 water’s-edge election is in effect, and shall be limited to
25 providing that information necessary to review or adjust income
26 or deductions in a manner authorized by Section 482, 861,
27 Subpart F of Part III of Subchapter N, or similar provisions, of
28 the Internal Revenue Code, together with the regulations adopted
29 pursuant to those provisions, and for the conduct of an
30 investigation with respect to any unitary business in which the
31 taxpayer may be involved.

32 (B) Agrees that, for purposes of this article, dividends received
33 by any corporation whose income and apportionment factors are
34 taken into account pursuant to subdivision (a) from either of the
35 following are functionally related dividends and shall be
36 presumed to be business income:

37 (i) A corporation of which more than 50 percent of the voting
38 stock is owned, directly or indirectly, by members of the unitary
39 group and which is engaged in the same general line of business.

1 (ii) Any corporation that is either a significant source of
2 supply for the unitary business or a significant purchaser of the
3 output of the unitary business, or that sells a significant part of its
4 output or obtains a significant part of its raw materials or input
5 from the unitary business. “Significant,” as used in this
6 subparagraph, means an amount of 15 percent or more of either
7 input or output.

8 All other dividends shall be classified as business or
9 nonbusiness income without regard to this subparagraph.

10 (3) The definitions and locations of property, payroll, and
11 sales shall be determined under the laws and regulations that set
12 forth the apportionment formulas used by the individual states to
13 assign net income subject to taxes on, or measured by, net
14 income in that state. If a state does not impose a tax on, or
15 measured by, net income or does not have laws or regulations
16 with respect to the assignment of property, payroll, and sales, the
17 laws and regulations provided in Article 2 (commencing with
18 Section 25120) shall apply.

19 Sales shall be considered to be made to a state only if the
20 corporation making the sale may otherwise be subject to a tax on,
21 or measured by, net income under the Constitution or laws of the
22 United States, and shall not include sales made to a corporation
23 whose income and apportionment factors are taken into account
24 pursuant to subdivision (a) in determining the amount of income
25 of the taxpayer derived from or attributable to sources within this
26 state.

27 (4) “The United States” means the 50 states of the United
28 States and the District of Columbia.

29 (c) All references in this part to income determined pursuant to
30 Section 25101 shall also mean income determined pursuant to
31 this section.

32 SEC. 3. (a) Section 25110 of the Revenue and Taxation
33 Code, as added by Section 2 of this act, shall apply to taxable
34 years beginning on or after January 1, ~~2007~~ 2006, of a taxpayer
35 that determines its income derived from, or attributable to,
36 sources within this state pursuant to a water’s-edge election, if
37 either of the following conditions is satisfied.

38 (1) The water’s-edge election is made on or after January 1,
39 ~~2007~~ 2006.

1 (2) The water's-edge election was made prior to January 1,
2 2007 2006, and that election may be terminated for that taxable
3 year without the consent of the Franchise Tax Board pursuant to
4 paragraph (9) of subdivision (c) of Section 25113 of the Revenue
5 and Taxation Code.

6 ~~(b) It is the intent of the Legislature that, in connection with~~
7 ~~any matter governed by Section 25110 of the Revenue and~~
8 ~~Taxation Code, as amended by Section 1 of this act, no inference~~
9 ~~be drawn from the provisions of Section 25110 of the Revenue~~
10 ~~and Taxation Code, as added by this act.~~

11 *(b) Section 25110 of the Revenue and Taxation Code, as*
12 *added by Section 2 of this act, shall not apply to taxable years*
13 *beginning on or after January 1, 2006, of a taxpayer that*
14 *determines its income derived from, or attributable to, sources*
15 *within this state pursuant to a water's-edge election made prior*
16 *to January 1, 2006, where that election may not be terminated*
17 *for that taxable year without the consent of the Franchise Tax*
18 *Board pursuant to paragraph (9) of subdivision (c) of section*
19 *25113 of the Revenue and Taxation Code.*

20 *(c) In the case of any taxpayer that remains subject to the*
21 *provisions of Section 1 of this act after the application of*
22 *subdivisions (a) and (b) of this section, it is the intent of the*
23 *Legislature that both of the following apply:*

24 *(1) With respect to any original or amended return with a*
25 *water's-edge combined report filed on or before January 1,*
26 *2006, a taxpayer that excluded the income of its controlled*
27 *foreign corporation because the controlled foreign corporation*
28 *established nexus in this state or because it had United*
29 *States-source income shall be deemed to be in compliance with*
30 *the provisions of Section 25110 of the Revenue and Taxation*
31 *Code, as it read prior to the enactment of this act, provided that*
32 *the taxpayer otherwise complied with the provisions of that*
33 *section.*

34 *(2) With respect to any original or amended return with a*
35 *water's-edge combined report filed after January 1, 2006, no*
36 *inference shall be drawn from the provisions of Section 25110 of*
37 *the Revenue and Taxation Code, as added by this act, as to*
38 *whether a taxpayer properly excluded the income of its*
39 *controlled-foreign corporation because the controlled foreign*
40 *corporation established nexus in this state or because it had*

1 *reported the United States-source income under Section 25110 of*
2 *the Revenue and Taxation Code, as it read prior to the enactment*
3 *of this act.*

4 *SEC. 4. This act provides for a tax levy within the meaning of*
5 *Article IV of the Constitution and shall go into immediate effect.*

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